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TAGS: EFIN EREL ETRD PGOV PREL UP XH
SUBJECT: IMF MAY EXPAND IN UKRAINE, DESPITE LACK OF REFORMS

Classified By: CDA James Pettit for reasons 1.4 (b) and (d)

¶1. (C) Summary. With Ukraine's sovereign debt reaching 30 percent of GDP, primarily in short- to medium-term instruments, and doubts increasing about Ukraine's intentions to implement macroeconomic reforms, many in Kyiv are predicting the need for continued IMF lending beyond the current program. Even the IMF's Kyiv-based resident representative Max Alier mused that an expansion of the Fund's program for Ukraine could occur in 2010, "not necessarily because Ukraine would need the money," but in order to boost market confidence. Separately, private sector analysts predicted such an expansion of the IMF program was inevitable, given that macroeconomic imbalances were projected to last through next year. British counterparts are reviewing Ukraine's commitments and IMF flexibility and may suggest greater U.S.-U.K. coordination to push through reform. End summary.

IMF Considers Expanding Program?

¶2. (C) The IMF's Alier told us on August 19 that he could envision an extension of the IMF program after the current one ends in 2010, "not necessarily because Ukraine would need the money," but rather to bolster the confidence of investors and the international community. Alier's statement was consistent with previous informal comments made to us, in which he had noted that the IMF would have to wait until after presidential elections to negotiate an expansion of the program, due to the lack of credible interlocutors among Ukraine's authorities. Alier confirmed that the IMF had not initiated any discussions with the GOU on a program expansion.

¶3. (C) Separately, analysts at the Kyiv offices of Russian investment bank Troika Dialog told us on August 19 that the IMF would have to establish a precautionary lending program after the current 11 billion SDR ($17.1 billion at August 2009 exchange rates) Stand-By Arrangement concludes. Reforms in the energy sector will be too "sluggish" to have much effect on the fiscal deficit, and the exchange rate and banking sector would remain volatile due to the country's 2009 GDP decline, forecast by the IMF to be 14 percent. The Troika analysts said recent equity market optimism was "not justified," and that there was a strong likelihood of another correction in the stock market, given the skittish, herd-like behavior of investors who have disproportionately reacted to IMF signals.

¶4. (C) Troika analysts also expected a second wave of banking sector defaults in Ukraine and throughout Eastern Europe, pointing to recent comments made to their investors

by Raiffeisen International CEO Herbert Stepich. Stepich apparently stated that Austria-based Raiffeisen expected the wave to come after September 2009, due to a "6-8 month lag after the underlying macroeconomic event" (i.e. a 20.3 percent real GDP decline year-on-year in the first quarter of 2009). On the positive side, Troika analysts believed Ukraine could grow out of its budget problems by 2012 without drastic structural reforms if the IMF were to stay beyond ¶2010. They also said that investors were looking to the IMF to co-draft Ukraine's 2010 state budget to avoid excess populist spending and push pension reform. Alier confirmed to us that IMF experts will, in fact, assist the GOU in formulating the 2010 budget.

¶5. (C) Mounting market expectations of a longer-term Fund presence, combined with IMF representative Alier's comments about a program expansion, have led to speculation about how tough the IMF will be on Ukraine's current authorities in this pre-election period. Alier admitted that the next mission review would be very difficult and that IMF officials were "not looking forward" to future negotiations.

U.K Proposes Review of Ukraine Economic Policy
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¶6. (C) Concerned about the "extraordinary flexibility" the IMF has shown with Ukraine and the possibility of further fiscal and banking problems, British Embassy counterparts said that their Foreign Office and Treasury in London are reviewing the U.K.'s economic policy toward Ukraine and may be looking for coordination with the United States on an approach to the IMF. British Embassy officials have picked

up on general concerns voiced in Kyiv that it could be considered "meddling" in Ukraine's presidential elections if Western powers were not to demand the implementation of already-promised reforms from the Tymoshenko government over the next six months.

Comment

¶7. (C) Upcoming presidential elections next January, combined with expected parliamentary elections later in 2010, mean few in Ukraine foresee implementation of serious economic reforms, such as budget tightening or increases in consumer gas prices. As a result, key IMF conditionalities are likely to be largely unmet in the next six months. Looking down the road, this leaves Ukraine with a sovereign debt burden of as much as 30 percent of GDP and the possibility of continued budgetary shortfalls. Although some remain optimistic that Ukraine can "grow" itself out of its macroeconomic troubles, current Ukrainian authorities may be missing an opportunity to correct fiscal imbalances as well as display leadership for a population that is already hardened for tougher anti-crisis measures.

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